STATE OF NEW MEXICO
ENERGY, MINERALS AND NATURAL RESOURCES DEPARTMENT
OIL CONSERVATION COMMISSION

IN THE MATTER OF THE HEARING CALLED BY THE OIL CONSERVATION COMMISSION FOR THE PURPOSE OF CONSIDERING:

APPLICATION OF MATADOR PRODUCTION COMPANY FOR A NON-STANDARD OIL SPACING AND PRORATION UNIT AND COMPULSORY POOLING, LEA COUNTY, NEW MEXICO. **Case No. 15363 (*de novo*)**
Order No. R-14053-E

ORDER OF THE COMMISSION

BY THE COMMISSION:

This matter came on for hearing at 9:00 a.m. on August 25, 2016, 10:00 a.m. on September 6, 2016, 9:00 a.m. on September 7, 2016, and 10:00 a.m. on October 17, 2016, at Santa Fe, New Mexico, before Oil Conservation Commission (the "Commission").

NOW, on this 10th day of November, 2016, the Commission, having considered the testimony and the record,

FINDS THAT:

(1) Due notice has been given, and the Commission has jurisdiction of this case and of the subject matter.

(2) Matador Production Company ("Applicant" or "Matador") seeks approval of a non-standard 154.28-acre oil spacing and proration unit and project area (the "Unit") in the Airstrip-Wolfcamp Pool (Pool code 970) comprised of Lots 1-4 (the W/2W/2 equivalent) of Section 31, Township 18 South, Range 35 East, NMPM, Lea County, New Mexico. Applicant further seeks the pooling of all uncommitted interests in the Unit for the Wolfcamp formation.

(3) The Unit will be dedicated to Applicant's Airstrip 31 18 35 RN State Com Well No. 201H (the "proposed well;" API No. 30-025-41678), a horizontal well to be drilled from a surface location in Lot 4, to a terminus in Lot 1, both in Section 31, Township 18 South, Range 35 East, NMPM. The completed interval of the proposed well is entirely within the prescribed setbacks from the outer boundaries of the project area.

(4) Spacing in the Airstrip-Wolfcamp Pool is governed by 19.15.15.9(A) NMAC, which provides for standard 40-acre units, each comprising a

governmental quarter-quarter section. The Unit and project area consists of four adjacent quarter-quarter sections.

(5) Jalapeno Corporation ("Jalapeno") and Yates Energy Corporation ("Yates") entered appearances in the Oil Conservation Division (the "Division") proceeding, and took part in the proceeding. Yates is not a party to the *de novo* proceeding.

(6) The following proceedings took place before the Division:

(a) Jalapeno and Yates filed a Motion to Dismiss Application for Non-Standard Oil Spacing Project Area. The Motion to Dismiss was denied by Division Order No. R-14053.

(b) Jalapeno and Yates filed an application for hearing *de novo* on Order No. R-14053. The *de novo* application was stayed by Commission Order No. R-14053-A, pending a decision on the merits of the case.

(c) The Division entered Order No. R-14053-B on the merits of the case, granting Matador's application but reducing the pooling risk charge to 133%. Both Jalapeno and Matador filed *de novo* applications on Order No. R-14053-B.

(7) The following proceedings took place before the Commission:

(a) Commission Order No. R-14053-C was entered lifting the stay imposed by Order No. R-14053-A, and combining all *de novo* applications for purposes of hearing.

(b) Jalapeno filed a Motion to Dismiss and Declare the Rights and Obligations of Parties in a Pooling Application Under NMSA 1978, §70-2-17.

(c) Commission Order No. R-14053-D scheduled proceedings before the Commission. A hearing on the Motion to Dismiss was scheduled for August 25, 2016. An evidentiary hearing on the merits of Matador's application was scheduled for September 6, 2016. That hearing was held but continued to September 7, 2016 and October 17, 2016 to hear all evidence in the case.

(8) Before the August 25, 2016 hearing the Division and the New Mexico Oil and Gas Association ("NMOGA") filed motions to intervene in the *de novo* proceeding.

(9) At the hearing on August 25, 2016, the Commission granted the motion to intervene of the Division, and denied the motion to intervene of NMOGA.

(10) Further, at the hearing on August 25, 2016, Jalapeno and Matador presented arguments on the Motion to Dismiss, summarized below:

(a) Jalapeno argued that the Commission (and the Division):

(i) has no authority under statute or rule to form a non-standard unit comprised of adjacent quarter-quarter sections for a horizontal well spacing or proration unit, nor to pool such a non-standard unit.

(ii) 19.15.13.8 NMAC is invalid and contrary to statute to the extent it authorizes the assessment of a 200% risk charge in a pooling order without the need for an applicant to provide evidence supporting the charge, and puts the burden on the party opposing the application to justify a lower risk charge.

(iii) a risk charge can be assessed against the costs of drilling and completing a well, but should not be assessed on surface equipment.

(b) Matador contended that:

(i) non-standard spacing and proration units for horizontal wells are permitted under statute, rules, and judicial decisions.

(ii) statutory authority, Division and Commission orders, and judicial decisions allow the compulsory pooling of non-standard spacing and proration units for horizontal wells.

(iii) 19.15.13.8 NMAC is a valid rule duly adopted by the Commission, and constitutes a sound exercise of the Commission's discretion.

(iv) "completion" of a well, especially with respect to unconventional reservoirs such as the Wolfcamp formation, should include the cost of surface equipment, and therefore a risk charge on surface equipment is proper.

The Commission concludes as follows on the Motion to Dismiss:

(11) Nothing in the Oil and Gas Act specifies a "standard" spacing unit for oil or gas wells.

(12) A non-standard spacing and proration unit can be established by rule, or by Division or Commission order.

(13) A proration unit is the area which can efficiently and economically be drained by a well, and pooling of non-standard spacing and proration units is allowed by NMSA 1978, §70-2-17 for the area drained by a well.

(14) 19.15.13.8 NMAC is a reasonable interpretation of the pooling statutes.

(15) The Motion to Dismiss should be denied.

(16) At the hearings on September 6 and 7, 2016 and October 17, 2016, Applicant appeared and presented the following evidence:

(a) Notice of the proposed Unit was provided to all surrounding affected parties within the Wolfcamp formation.

(b) Notice of this compulsory pooling application was provided to all uncommitted working interest owners in the Unit.

(c) The mineral estate within the Unit is owned by the State of New Mexico under two leases administered by the State Land Office.

(d) Applicant owns approximately 93% of the working interest in the proposed well, and another 4% of the working interest has voluntarily joined in the well. Applicant seeks to pool the remaining 3% of the working interest, owned by Jalapeno and two other entities (who did not appear in the case).

(e) Applicant has been negotiating with the working interest owners in the Unit since March 2015 to obtain their voluntary joinder. There has been substantial contacts between Applicant and Jalapeno, including letters, phone contacts, e-mail, and personal meetings.

(f) The biggest issue between applicant and Jalapeno has been the risk charge assigned against non-consenting interest owners, whether through an operating agreement or pooling order. Matador asserted that a cost plus 200% risk charge is justified not only by the facts of this case but it is standard throughout the industry, and that Jalapeno did not submit sufficient evidence to reduce the charge.

(g) Applicant has made a good faith effort to obtain the voluntary joinder in the proposed well of all working interest owners.

(h) The proposed well is designed to test the upper Wolfcamp formation. The nearest comparable upper Wolfcamp well is over 50 miles away in west Texas. Thus, the proposed well is a wildcat well.

(i) Upper Wolfcamp wells in Eddy County, 45 miles away, test a zone that is not present in the Northern Permian Basin.

(j) The nearest Wolfcamp test in this area is a lower Wolfcamp test more than 5 miles away.

(k) Older, vertical Wolfcamp wells within 5 miles of the proposed well were only commercial about 15% of the time, which is normal for wildcat areas.

(l) While the Wolfcamp is geologically present in this area, and the formation is continuous across the Unit, there is still significant geologic risk due to unknown or uncertain total organic carbon, thermal maturity, and brittleness (fracturability). Applicant assigns the chance of geologic success for the proposed well at 25%.

(m) The area is suitable for development by horizontal drilling.

(n) The proposed orientation of the horizontal well from South to North is appropriate for the proposed Unit;

(o) All quarter-quarter sections within the Unit are expected to be equally productive in the Wolfcamp formation, so that formation of the Unit will not impair correlative rights.

(p) While operational risk is lower, the nearest Wolfcamp well, approximately 5 miles away from the proposed well, encountered drilling difficulties and cost $17,000,000 to drill and complete. Applicant assigns the chance of operational success for the proposed well at 75%.

(q) Additional drilling costs include a deeper well, a fourth casing string, heavier drilling mud weight, and a larger stimulation program. Thus Wolfcamp well costs are significantly higher than for a Bone Spring well.

(r) The proposed AFE of approximately $6,500,000 is fair and reasonable.

(s) The chance of reservoir success is 50% due to unknown factors such as permeability, water saturation, formation pressure gradient, and reservoir continuity.

(t) The proposed well classifies only as a contingent resource, and not reserves, under Security and Exchange Commission regulations.

(u) To make the well economic the well must produce 400,000 barrels of oil, not 200,000-250,000 as asserted by Jalapeno.

(v) Using Bone Spring well data to prove risk in a Wolfcamp well is improper.

(w) The probability of success of the proposed well is determined by multiplying the geologic, operational, and reservoir risk factors, which is approximately 10%. Thus, a 200% risk charge against non-consenting working interest owners is justified.

(x) While Jalapeno testified that it will receive no benefit from the proposed well, the drilling of the proposed well will provide data to Matador, Jalapeno, and all other interest owners regarding the drilling of Wolfcamp wells in the general area of the proposed well.

(y) Even if the proposed well does not pay out, royalty interest and overriding royalty interest owners will be paid their proportionate share of production proceeds.

(z) Supervision rates of $7000/month for a drilling well and $700/month for a producing well are fair and reasonable.

(17) At the hearings on September 6 and 7, 2016 and October 17, 2016, Jalapeno appeared and presented the following evidence:

(a) A statistical study of Bone Spring wells in a four township area in Lea County, including Township 18 South, Range 35 East, NMPM shows the geologic risk and operational risk is minimal, and the reservoir risk is relatively low, and that a 50-66% risk charge is proper for the proposed well.

(b) Any risk associated with low commodity prices should be borne by Applicant.

(c) Even though the risk involved in drilling the proposed well is low, Jalapeno would not commit to joining in the proposed well.

The Commission concludes as follows:

(18) Approval of the Unit will enable Applicant to drill a horizontal well in the Wolfcamp formation that will efficiently produce the reserves underlying the Unit, thereby preventing waste, and will not impair correlative rights.

(19) Two or more separately owned tracts are embraced within the Unit and/or there are royalty interests and/or undivided interests in oil and gas minerals in one or more tracts included in the Unit that are separately owned.

(20) MRC Delaware Resources, LLC is the owner of an oil and gas working interest within the Unit. Applicant is an affiliate of MRC Delaware Resources, LLC and operates its wells. Thus, Applicant has the right to drill and proposes to drill the proposed well to a common source of supply within the Unit.

(21) There are interest owners in the Unit who have not agreed to pool their interests.

(22) To avoid the drilling of unnecessary wells, protect correlative rights, prevent waste, and afford to each interest owner the opportunity to recover or receive without unnecessary expense its just and fair share of hydrocarbons, this

application should be approved by pooling all uncommitted interests, whatever they may be, in the oil and gas within the Unit.

(23) The Unit should include the entire Wolfcamp formation.

(24) Pooling a well unit under NMSA 1978, §70-2-17 does not constitute a "taking" of a working interest owner's property.

(25) Matador Petroleum Company (OGRID No. 228937) should be designated the operator of the proposed well and of the Unit.

(26) NMSA 1978, §70-2-17(C) allows a risk charge for drilling and completing a well. 19.15.13.8(D) NMAC allows a person contesting a risk charge to seek a different risk charge.

(27) Evidence presented by both parties proves there are risks involved in drilling and completing the proposed well. The risk for the proposed well should be reduced for operational and geologic reasons.

(28) Lack of horizontal upper Wolfcamp development in the area of the proposed well justifies classifying it as a wildcat well. Thus, a risk charge of 150% is justified in this case. However, the risk charge should not cover surface equipment.

(29) Any pooled working interest owner who does not pay its share of estimated costs should have withheld from production its share of reasonable well costs plus an additional 150% thereof as a reasonable charge for the risk involved in drilling and completing the proposed well, but not as to surface equipment.

(30) Reasonable charges for supervision (combined fixed rates) should be fixed at $7000 per month while drilling and $700 per month while producing, provided that these rates should be adjusted annually pursuant to Section III.1.A.3 of the COPAS form titled "*Accounting Procedure-Joint Operations.*"

IT IS THEREFORE ORDERED THAT:

(1) Jalapeno's Motion to Dismiss and Declare the Rights and Obligations of Parties in a Pooling Application Under NMSA 1978, §70-2-17 is denied.

(2) The application of Matador Production Company ("Applicant" or "Matador") for approval of a non-standard 154.28-acre oil spacing and proration unit and project area (the "Unit") in the Airstrip-Wolfcamp Pool (Pool code 970) comprised of Lots 1-4 (the W/2W/2 equivalent) of Section 31, Township 18 South, Range 35 East, NMPM, Lea County, New Mexico, and the pooling of all uncommitted interests in the Unit for the Wolfcamp formation, is hereby approved.

(3) The Unit shall be dedicated to Applicant's Airstrip 31 18 35 RN State Well No. 201H (API No. 30-025-41678), a horizontal well to be drilled from a

surface location in Lot 4, to a terminus in Lot 1, both in Section 31, Township 18 South, Range 35 East, NMPM. The completed interval of the proposed well is within the prescribed setbacks from the outer boundaries of the project area.

(4) Matador Petroleum Company (OGRID No. 228937) is hereby designated the operator of the proposed well and of the Unit.

(5) The operator of the Unit shall commence drilling the proposed horizontal well on or before November 30, 2017 and shall thereafter continue drilling the well with due diligence to test the Wolfcamp formation.

(6) In the event the operator does not commence drilling the proposed well on or before November 30, 2017, Ordering Paragraphs (2) and (3) shall be of no effect, unless the operator obtains a time extension from the Division Director for good cause demonstrated by satisfactory evidence.

(7) Should the proposed well not be drilled and completed within 120 days after commencement thereof, then Ordering Paragraphs (2) and (3) shall be of no further effect, and the Unit and project area created by this Order shall terminate, unless operator appears before the Division Director and obtains an extension of the time for completion of the proposed well for good cause shown by satisfactory evidence. If the proposed well is not completed in all of the standard spacing units included in the proposed project area (or Unit), the operator shall apply to the Commission for an amendment to this Order to contract the Unit so that it includes only those quarter-quarter sections in which the well is completed.

(8) Upon final plugging and abandonment of the proposed well and any other well drilled on the Unit pursuant to 19.15.13.9 NMAC, the pooled Unit created by this Order shall terminate, unless this Order has been amended to authorize further operations.

(9) After pooling, uncommitted working interest owners are referred to as pooled working interest owners. ("Pooled working interest owners" are owners of working interests in the Unit, including unleased mineral interests, who are not parties to an operating agreement governing the Unit.) After the effective date of this order, the operator shall furnish the Division and each known pooled working interest owner in the Unit an itemized schedule of estimated costs of drilling, completing, and equipping the proposed well ("well costs").

(10) Within 30 days from the date the schedule of estimated well cost is furnished to him, any non-consenting working interest owner shall have the right to pay his share of estimated well costs to Applicant in lieu of paying his share of reasonable well costs out of production, and any such owner who pays his share of estimated well costs as provided above shall remain liable for operating costs but shall not be liable for risk charges. Pooled working interest owners who elect not to pay their share of estimated well costs as provided in this paragraph shall thereafter be referred to as "non-consenting working interest owners".

(11) The operator shall furnish the Division and each known working interest owner an itemized schedule of actual well costs within 90 days following completion of the well; if no objection to the actual well costs is received by the Division and the Division has not objected within 45 days following receipt of said scheduled, the actual well costs shall be the reasonable well costs; provided, however, that if there is objection to actual well costs within said 45-day period the Division will determine reasonable well costs after public notice and hearing.

(12) Within 60 days following the determination of reasonable well costs, any pooled working interest owner who has paid his or its share of estimated costs in advance as provided above shall pay to Applicant his or its share of the amount that reasonable well costs exceed estimated well costs or shall receive from Applicant the amount, if any, that the estimated well costs that he or it has paid exceed his or its share of reasonable well costs.

(13) The operator is hereby authorized to withhold the following costs and charges from production:

(a) the proportionate share of reasonable well costs attributable to each non-consenting working interest owner; and

(b) as a charge for the risk involved in drilling and completing the well, 150% of the above costs. Costs of surface equipment shall not be subject to the risk charge, although actual costs can be recovered.

(14) The operator shall distribute the costs and charges withheld from production, proportionately, to the parties who advanced the well costs.

(15) Reasonable charges for supervision (combined fixed rates) are hereby fixed at $7000 per month while drilling and $700 per month while producing, provided that these rates shall be adjusted annually pursuant to Section III.1.A.3. of the COPAS form titled "*Accounting Procedure-Joint Operations.*" The Operator is authorized to withhold from production the proportionate share of both the supervision charges and the actual expenditures required for operating the well, not in excess of what is reasonable, that are attributable to the pooled working interest owners.

(16) Except as provided in Paragraphs (13) and (15) above, all proceeds from production from the well that are not disbursed for any reason shall be held for the account of the person or persons entitled thereto pursuant to the Oil and Gas Proceeds Payment Act (NMSA 1978, §§ 70-10-1 through 70-10-6, as amended). If not disbursed, such proceeds shall be turned over to the appropriate authority as and when required under the Uniform Unclaimed Property Act (NMSA 1978, §§ 7-8A-1 through 7-8A-28, as amended).

(17) Should all of the parties to this compulsory pooling order reach voluntary agreement subsequent to the entry of this order, the order shall thereafter be of no further effect.

(18) The operator of the well and Unit shall notify the Commission in writing of the subsequent voluntary agreement of all parties subject to the forced pooling provisions of this order.

(19) Jurisdiction over this case is retained for the entry of such further orders as the Commission may deem necessary.

DONE at Santa Fe, New Mexico, on the day and year designated above.

STATE OF NEW MEXICO
OIL CONSERVATION COMMISSION

ROBERT BALCH, MEMBER

PATRICK PADILLA, MEMBER

DAVID CATANACH, CHAIRMAN

SEAL